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No. 87-529

In the Supreme Court of the United States

OCTOBER TERM, 1987

JAMES POLAKOF, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioners contend in this tax shelter case that the court of appeals erred in upholding the Tax Court's finding that the acquisition and distribution of motion pictures by their partnerships were activities not engaged in for profit because the partnerships lacked a "predominant" profit motive.

1. Petitioners are limited partners in one or more of four limited partnerships, which were organized by general partner Cinema Financial of America, Inc. (CFA) to acquire and distribute feature-length motion pictures.[1] Each partnership agreed, in advance of production, to acquire a film to be produced by a CFA affiliate for a cash down payment plus a nonrecourse note payable solely

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[1] A list of the various partnerships, and petitioners' respective interests in them, is set forth in the opinion of the Tax Court (Pet. App. A15 n.5, A22 n.6, A26 n.7, A29).

from the net proceeds of the distribution of the film.[2] The prices of the films were established in the partnership prospectuses and were not negotiated (Pet. App. A48-A49, A75-A76).

Early investor tax benefits were a major selling point in CFA's offerings for partnership interests. The offering materials prepared by CFA devoted several paragraphs to explaining the income tax benefits of the investment (see Pet. App. A11-A13). They also explained that the respective partnerships' payments to CFA might include prepayments of interest, management fees, and other costs of promotion and distribution, in addition to the price of the film (*id.* at A14). The films were box office failures (see *id.* at A47, A58). No cash distributions were made by the partnerships to petitioners, and no payments were ever made with respect to the principal of the nonrecourse notes (*id.* at A14-A15).

For each of the years in issue (ranging variously from 1973 to 1977), petitioners claimed on their individual income tax returns their distributive shares of the investment tax credit and the expenses incurred by the partnerships in acquiring and distributing the films. On audit, the Commissioner disallowed the claimed deductions and credits on the grounds that the partnerships' movie distribution activities were activities "not engaged in for profit" within

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[2] The purchase prices for the movies were as follows: (1) *Silence*, $625,000, consisting of $125,000 in cash and a nonrecourse note payable to CFA in the amount of $500,000 (Pet. App. A16); (2) *He Is My Brother*, $1,425,000, consisting of $225,000 in cash and a nonrecourse note payable to CFA in the amount of $1,200,000 (*id.* at A22); (3) *Sunburst*, $1,425,000, consisting of $225,000 in cash and a nonrecourse note payable to CFA in the amount of $1,200,000 (*id.* at A26); and (4) *How to Become a Movie Star*, $115,000, consisting of $25,000 in cash and a nonrecourse note payable to CFA in the amount of $90,000 (*id.* at A29).

the meaning of Section 183(a) of the Internal Revenue Code.[3] The Commissioner also concluded that no interest deductions were allowable because the nonrecourse notes did not constitute genuine debt. Pet. App. A32-A33.

Petitioners sought redetermination of the resulting deficiencies in the Tax Court, which upheld the Commissioner's determinations (Pet. App. A1-A69). The court, weighing expert testimony, found that the partnerships acquired the films at grossly inflated prices (*id.* at A44), due primarily to CFA's affiliation with the producers (*id.* at A48) and in part to the fact that the prices had not been subject to negotiation (*id.* at A49). The court observed that, in any event, there was no incentive to bargain over the film prices because the tax benefits advertised to investors increased directly with the amount of the nonrecourse debts, and the notes were payable only from distribution proceeds, if any (*id.* at A50). Since the court found that CFA exhibited a general disregard for production quality (*id.* at A60-A61), seriously depleted partnership capital by prepaying interest and management fees to itself (*id.* at A53-A54), used the expensive and risky "four-walling" method of distributing one film when the industry had generally abandoned the technique (*id.* at A67), and had no personnel with any prior experience in motion picture distribution (*id.* at A59-A60), the court concluded that the entire operation had been conducted in an extremely unbusinesslike manner and was not designed to make a profit (*id.* at A43-A44). Observing that there was "no reasonable prospect from the beginning that the movies would ever produce enough net revenue to permit [petitioners] to recover their cash investment, let alone pay the nonrecourse notes and make a profit," the court inferred that the scheme was designed primarily "to garner tax benefits" for petitioners (*ibid.*).

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[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

With respect to the interest deductions, which are available even to taxpayers who are not engaged in a trade or business for profit (see I.R.C. § 183(b)(1)), the Tax Court disallowed the claimed deductions because it found that the nonrecourse notes were not genuine indebtedness (Pet. App. A68-A69). The court reasoned that, because the amounts of the nonrecourse notes bore "no relationship" to the films' respective fair market values (*id.* at A55), there was no economic incentive to pay off the notes. Accordingly, the court concluded that those obligations did not constitute genuine indebtedness for which interest deductions are allowable (*id.* at A69).

3. The court of appeals affirmed (Pet. App. A70-A100). The court, observing that the question whether an activity is carried on for profit "is determined by reference to objective standards and examination of all facts and circumstances" (*id.* at A80), upheld as not clearly erroneous the Tax Court's finding that "the primary purpose of the partnerships in buying the film properties was to create tax shelters, not to profit" (*id.* at A81-A82). The court of appeals also upheld the Tax Court's conclusion that petitioners were not entitled to interest deductions claimed with respect to the nonrecourse notes because the amounts of those notes "greatly exceeded the films' values" (*id.* at A82).

4. Petitioners contend that the partnerships' acquisition and distribution of the films were in fact activities engaged in for profit (Pet. 17-24) and that the interest paid on the nonrecourse notes should be deductible (*id.* at 24-25). These factbound contentions were correctly rejected by both courts below. The court of appeals' decision does not conflict with any decision of this Court or of any other court of appeals. Accordingly, there is no reason for review by this Court.

a. Petitioners' basic contention (Pet. 17-25) is that the courts below applied an incorrect standard to the "profit motive" inquiry in requiring the partnerships to demonstrate that their "predominant, primary or principal" purpose in acquiring and distributing the films was to derive a profit. Petitioners advance little support for this proposition. Whether or not they use the precise word "predominant," the courts of appeals that have addressed the issue have generally agreed that the "profit motive" must be dominant in order to render expenses deductible as trade or business expenses, and no court of appeals has rejected that standard. See, *e.g.*, *Simon* v. *Commissioner*, 830 F.2d 499, 500 (3d Cir. 1987); *Thomas* v. *Commissioner*, 792 F.2d 1256, 1259 (4th Cir. 1986); *Independent Electric Supply, Inc.* v. *Commissioner*, 781 F.2d 724, 726 (9th Cir. 1986); *Tallal* v. *Commissioner*, 778 F.2d 275, 276 (5th Cir. 1985); *Brannen* v. *Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984); *Eastman* v. *United States*, 635 F.2d 833, 837 (Ct. Cl. 1980).[4] Indeed, this Court has recognized the general applicability of this approach, stating that "[t]he standard test for the existence of a trade or business for purposes of Section 162 is whether the activity 'was entered into with the dominant hope and intent of realizing a profit.' " *United States* v. *American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986), (quoting *Brannen* v.

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[4] Petitioners rely (Pet. 23) upon *Johnson* v. *United States*, 11 Cl. Ct. 17 (1986), where the Claims Court found that "a primary or dominant standard is not appropriate in the business setting" (*id.* at 26). This Claims Court decision plainly does not establish a conflict in the circuits and provides no basis for review by this Court. In any event, we note that, even under the test posited by petitioners and the Claims Court, the Tax Court's findings here are inconsistent with holding the partnerships' activities to be "for profit." The Tax Court found that the overpricing of the films "doom[ed] the partnerships to financial failure" (Pet. App. A49) and that it was "inconsistent with an actual and honest objective of making a profit" (*id.* at A53). Petitioners offer no reason for doubting the correctness of these findings.

Commissioner, 722 F.2d at 704). Accordingly, there is no reason for this Court to disturb the conclusion of both courts below that the partnerships' activities were not for profit.

b. Petitioners also contend (Pet. 24-25) that the courts below erred in denying them deductions for interest paid with respect to the nonrecourse notes. The only basis offered for this contention is the assertion (*ibid.*) that "application of the incorrect profit motive standard prejudiced the Courts [*sic*] view of the * * * indebtedness." It is not evident what the connection is between these two issues, but, in any event, the courts did not apply an incorrect standard to the profit motive inquiry (see point 4a, *supra*). The courts below simply adhered to the well-settled principle that nonrecourse notes that do not represent genuine indebtedness yield no interest deductions. See, *e.g.*, *Estate of Baron* v. *Commissioner*, 798 F.2d 65, 68 (2d Cir. 1986); *Odend'hal* v. *Commissioner*, 748 F.2d 908, 912 (4th Cir. 1984), cert. denied, 471 U.S. 1143 (1985). There is no basis for this Court to overturn their shared conclusion on this factual issue. See *Anderson* v. *City of Bessemer City*, 470 U.S. 564, 573-574 (1985).

It it therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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